

Office of Chief Counsel  
Internal Revenue Service

**memorandum**

CC:WR:SCA:SD:TL-N-7267-99

GAKindel

date: **JAN 11 2000**

to: Examination Division, Southern California District  
ATTN: Rick Woods, CE1108

from: Associate District Counsel, Southern California District, San Diego

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subject: [REDACTED]

This memorandum responds to your request for advice regarding the sale of [REDACTED], a wholly owned subsidiary of [REDACTED] (the "Taxpayer") and certain transactions associated with this sale.

DISCLOSURE LIMITATIONS

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

ISSUE

Whether [REDACTED]'s redemption of preferred stock held by [REDACTED] in [REDACTED] was "not essentially equivalent to a dividend" within the meaning of I.R.C. § 302(b)(1).

If the redemption of the preferred stock held by [REDACTED] was essentially equivalent to a dividend, whether the Service may disregard the issuance and redemption of the preferred stock for tax purposes because they lacked economic substance.

CONCLUSION

(b)(7)a

[REDACTED]

However, the Service may have an argument for disregarding the issuance and redemption of the preferred stock for tax purposes. It appears, from the information currently available, that the Taxpayer devised a scheme whereby it could withdraw \$[REDACTED] from [REDACTED] without experiencing a negative impact on its basis in [REDACTED] and therefore, the gain realized on the sale of [REDACTED]. The Taxpayer did not enjoy any economic benefit from the transaction and seemingly did not have any legitimate non-tax business purpose for the transaction. Nonetheless, we do not have sufficient information to reach any ultimate conclusions on the strength of this issue. Therefore, we recommend that you develop the issue further.

FACTS

## I. PLAYERS

[REDACTED] (the "Taxpayer") is a Delaware corporation engaged primarily as a government defense contractor. The Taxpayer and its subsidiaries file consolidated income tax returns on a fiscal year ending [REDACTED].

[REDACTED] is a California corporation incorporated in [REDACTED]. Prior to [REDACTED], [REDACTED] was a wholly owned subsidiary of the Taxpayer. The total authorized

number of shares of common stock is [REDACTED]. Prior to [REDACTED] [REDACTED] had only [REDACTED] shares of common stock issued and outstanding.

[REDACTED] is a California corporation wholly owned by the Taxpayer.

[REDACTED] is a Delaware corporation wholly owned by [REDACTED] a German Corporation. Neither [REDACTED] nor [REDACTED] is related to the Taxpayer or its affiliates.

## II. TRANSACTION

### A. NEGOTIATIONS FOR SALE OF [REDACTED] PRIOR TO [REDACTED]

As early as [REDACTED], the Taxpayer was engaged in negotiations with [REDACTED] for the sale of [REDACTED]. At that time, [REDACTED] offered to pay the Taxpayer \$[REDACTED] for [REDACTED]. See letter dated [REDACTED], from the Taxpayer to [REDACTED] (the "[REDACTED]"). Apparently, [REDACTED] retracted this proposal and made another offer that it believed reflected the [REDACTED] market at that time. The Taxpayer indicated, in the [REDACTED], that it "[REDACTED]" as offered previously by [REDACTED] but that it was "prepared to discuss a partnership with [REDACTED]." See [REDACTED]. In [REDACTED], the parties agreed on certain terms, including, the Taxpayer's right to take approximately \$[REDACTED] out of [REDACTED]. See letter dated [REDACTED], from [REDACTED] to the Taxpayer (the "[REDACTED]"). On or around [REDACTED], the parties executed a letter of intent setting forth the proposal by which [REDACTED] agreed to purchase [REDACTED]. See letter dated [REDACTED], from [REDACTED] to the Taxpayer (the "Letter of Intent").

### B. ISSUANCE OF PREFERRED STOCK BY [REDACTED]

On [REDACTED], the board of directors of [REDACTED] authorized the issuance of preferred stock and resolved to sell and issue:

[REDACTED]

See [REDACTED] dated [REDACTED] (the "[REDACTED]")

\_\_\_\_\_"). The board of directors did so in order to provide the necessary financing for "\_\_\_\_\_  
 \_\_\_\_\_" See id. At that time, \_\_\_\_\_ had been investigating "\_\_\_\_\_  
 \_\_\_\_\_." See id.

The holders of the Series A Preferred Stock issued by \_\_\_\_\_ were entitled to receive, when and as declared, dividends in cash at the rate of \$\_\_\_\_\_ per share per year. See Rights, Preferences, Privileges and Restrictions Relating to Series A Preferred Stock to be Issued by \_\_\_\_\_, ¶ \_\_\_\_\_. The holders' right to dividends was not cumulative. See id. Upon redemption, the holders were entitled to \$\_\_\_\_\_ per share plus any dividends declared and unpaid, if they redeemed their shares prior to \_\_\_\_\_. See id. at ¶ \_\_\_\_\_. They were entitled to \$\_\_\_\_\_ per share plus any dividends declared and unpaid, if they redeemed their shares after \_\_\_\_\_. See id. The holders of the Series A Preferred Stock had no voting rights. See id. at ¶ \_\_\_\_\_.

On \_\_\_\_\_'s Schedule \_\_\_\_\_ Balance Sheet, of the Taxpayer's consolidated U.S. Corporation Income Tax Return, Form 1120, for the taxable year ending \_\_\_\_\_, \_\_\_\_\_ reported an increase in cash of \$\_\_\_\_\_ and an increase in "other current assets" of \$\_\_\_\_\_ as follows:

	Balance	Balance
	_____	_____
Marketable Securities	\$ _____	\$ _____
Deferred Income Taxes	_____	_____
Prepaid Expenses	_____	_____
Total	\$ _____	\$ _____

\_\_\_\_\_ also reported an increase in capital stock of \$\_\_\_\_\_ in preferred stock. See \_\_\_\_\_'s Schedule \_\_\_\_\_ Balance Sheet, of the Taxpayer's consolidated U.S. Corporation Income Tax Return, Form 1120, for the taxable year ending \_\_\_\_\_.

#### C. REDEMPTION OF PREFERRED STOCK ISSUED BY \_\_\_\_\_

On \_\_\_\_\_, the board of directors of \_\_\_\_\_ resolved to redeem all of the Series A Preferred Stock for \$\_\_\_\_\_ per share. See Certificate of Resolution reflecting resolutions adopted by \_\_\_\_\_'s board of directors on \_\_\_\_\_ (the "\_\_\_\_\_"). The board of directors did so for the following reasons:

[REDACTED]

[REDACTED]

[REDACTED]

See id. The board of directors also resolved that, upon redemption, the capital of [REDACTED] should be reduced by \$ [REDACTED]. See id. On [REDACTED], [REDACTED] and [REDACTED] redeemed their shares of Series A Preferred Stock.

On [REDACTED]'s Schedule [REDACTED], Balance Sheet, attached to the Taxpayer's consolidated U.S. Corporation Income Tax Return, Form 1120, for the taxable year ending [REDACTED], [REDACTED] reported a decrease in cash of \$ [REDACTED] and a decrease in "other current assets" of \$ [REDACTED], as follows:

	Balance	Balance
	[REDACTED]	[REDACTED]
Marketable Securities	\$ [REDACTED]	\$ [REDACTED]
Deferred Income Taxes	[REDACTED]	[REDACTED]
Prepaid Expenses	[REDACTED]	[REDACTED]
Total	\$ [REDACTED]	\$ [REDACTED]

[REDACTED] reported a decrease in capital stock of \$ [REDACTED]. See [REDACTED]'s Schedule [REDACTED], Balance Sheet, attached to the Taxpayer's consolidated U.S. Corporation Income Tax Return, Form 1120, for the taxable year ending [REDACTED]. And [REDACTED] reported a decrease in retained earnings of \$ [REDACTED], computed as follows:

Balance as of	[REDACTED]	\$ [REDACTED]
Plus:		
Net Income per Books	[REDACTED]	
Rounding	[REDACTED]	
Less:		
Distributions of Cash	[REDACTED]	
Balance as of	[REDACTED]	\$ [REDACTED]

See [REDACTED]'s Schedule [REDACTED], Analysis of Unappropriated Earnings per Books, attached to the Taxpayer's consolidated Form 1120 for the taxable year ending [REDACTED].

On its books, [REDACTED] showed a decrease in retained earnings of \$ [REDACTED] and a decrease in capital stock of \$ [REDACTED]. See General Ledger Trial Balance (run date [REDACTED]) for [REDACTED]. [REDACTED] showed dividends paid of \$ [REDACTED]<sup>1</sup> as follows:

Date	Debit Amount	Running Balance
[REDACTED]	\$ [REDACTED]	\$ [REDACTED]
[REDACTED]	[REDACTED]	[REDACTED]

See id.

#### D. DISTRIBUTION MADE BY [REDACTED] TO THE TAXPAYER

On [REDACTED], [REDACTED] issued a dividend to the Taxpayer in the amount of \$ [REDACTED], which was reported as a distribution of cash in the amount of \$ [REDACTED] and a reduction in paid-in capital in the amount of \$ [REDACTED]. See [REDACTED]'s Schedule [REDACTED], Balance Sheets, and Schedule [REDACTED] Analysis of Unappropriated Retained earnings per Books, attached to the Taxpayer's Form 1120 for the taxable year ending [REDACTED].

#### E. STOCK PURCHASE AGREEMENT DATED [REDACTED]

On [REDACTED], the Taxpayer and [REDACTED] executed a Stock Purchase Agreement in which the Taxpayer agreed to sell all of the issued and outstanding common stock of [REDACTED] to [REDACTED]. As part of the Stock Purchase Agreement, on [REDACTED], the Taxpayer exchanged [REDACTED] of its [REDACTED] shares of the common stock in [REDACTED] for [REDACTED] shares of newly authorized and newly

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<sup>1</sup> We assume that [REDACTED] distributed these dividends on the Series A Preferred Stock.

issued Series A Preferred Stock of [REDACTED]. The Taxpayer then sold the remaining shares of common stock to [REDACTED] for \$ [REDACTED].

The Taxpayer received dividends in the amount of \$ [REDACTED] in each of the fiscal years ending [REDACTED], [REDACTED], [REDACTED] and [REDACTED] and claimed a deduction equal to [REDACTED] percent of these amounts on its federal income tax returns. In [REDACTED], the Taxpayer exercised its option to sell its [REDACTED] Series A Preferred Stock to [REDACTED] for \$ [REDACTED].

#### F. REPORTING OF SALE OF [REDACTED]

The Taxpayer reported a loss in the amount of \$ [REDACTED] on the sale of [REDACTED] to [REDACTED] on its U.S. Corporation Income Tax Return, Form 1120, for the taxable year ending [REDACTED]. The loss is disallowed pursuant to Treasury Regulation § 1.1502-20.

The Taxpayer reported the amount realized on the sale of [REDACTED] common stock as \$ [REDACTED]. The Taxpayer calculated its basis in [REDACTED] common stock as follows:

Investment in [REDACTED] as of [REDACTED]	\$ [REDACTED]
Book Income [REDACTED] to [REDACTED]	[REDACTED]
Redemption of [REDACTED] Preferred Stock Treated as Dividend	[REDACTED]
Nondeductible Reserves	[REDACTED]
Tax Return Adjustments Lookback Interest	[REDACTED]
Tax Effect of Adjustments Federal	[REDACTED]
State	[REDACTED]
[REDACTED]	[REDACTED]
Less Retained Earnings at [REDACTED]	[REDACTED]
Tax Basis before Preferred Stock	\$ [REDACTED]
Basis Allocable to Preferred Stock	[REDACTED]
Basis of Common Stock	\$ [REDACTED]

As noted above, the Taxpayer reported a loss of \$ [REDACTED] on the sale. The Taxpayer showed a book gain of \$ [REDACTED] on the sale.

### DISCUSSION

#### I. REDEMPTION OF PREFERRED STOCK ISSUED BY [REDACTED]

A redemption of stock by a corporation is treated as a distribution in part or full payment in exchange for the stock, if the redemption satisfies one of the following four tests:

1. the redemption is not essentially equivalent to a dividend;
2. the redemption is substantially disproportionate within the meaning of I.R.C. § 302(b)(2);
3. the redemption results in the complete termination of the shareholder's interest in the corporation; or
4. the redemption is made with respect to a non-corporate shareholder and is made in partial liquidation of the redeeming corporation within the meaning of I.R.C. § 302(b)(4).

I.R.C. §§ 302(a) and (b). If a redemption of stock does not meet ~~any of the tests described above, it is treated as a distribution~~ to which I.R.C. § 301 applies. I.R.C. § 302(d).

In our memorandum dated September 13, 1999, we advised you that the redemption of the Series A Preferred Stock held by [REDACTED] did not meaningfully reduce [REDACTED]'s ownership in [REDACTED] because, pursuant to I.R.C. § 318, [REDACTED] is treated as owning all of the common stock of [REDACTED] before and after the redemption. We concluded, therefore, that the redemption was essentially equivalent to a dividend. Because [REDACTED]'s earnings and profits ("E&P") exceeded the amount distributed to [REDACTED] in redemption of its preferred stock, the distribution is a dividend under I.R.C. § 301.

(b)(7)a

[REDACTED]

[REDACTED]

[REDACTED]

## II. SHAM TRANSACTION

Generally, a taxpayer has a right to decrease the amount of his income taxes by any means which the law permits. Gregory v. Helvering, 293 U.S. 465, 469 (1935). The means employed by the taxpayer, however, must have substance in addition to meeting the literal requirements of the statute. Id. In determining whether a transaction has sufficient substance to be respected for tax purposes, the courts have used a flexible analysis that focuses on two factors, objective economic substance, separate and apart from tax consequences, of the transaction and subjective business motivation behind the transaction. ACM Partnership v. Commissioner, 157 F.3d 231, 247 (3rd Cir. 1998), cert. denied, 526 U.S. 1017 (1999) (citing Casebeer v. Commissioner, 909 F.2d 1360, 1363 (9th Cir. 1990)).

**Economic Substance**

Economic substance is determined by objective evaluation of changes in economic position of the taxpayer aside from tax benefits. If a transaction is likely to produce economic benefits, other than tax benefits, it has economic substance. Winn-Dixie Stores, Inc. and Subsidiaries v. Commissioner, 113 T.C. No. 21 (1999); ACM Partnership, 157 F.3d at 248 (a transaction does not have economic substance where it does not appreciably affect the taxpayer's beneficial interest except to reduce its tax); Rice's Toyota World, Inc. v. Commissioner, 752 F.2d 89, 91 (4th Cir. 1985) (a transaction does not have economic substance where there is no reasonable possibility of profit from the transaction).

In this case, [REDACTED] issued preferred stock to [REDACTED] in exchange for \$ [REDACTED] and, [REDACTED], redeemed all of that preferred stock for \$ [REDACTED]. In addition, during [REDACTED], [REDACTED] distributed approximately \$ [REDACTED] as dividends to [REDACTED], therefore, received a return of approximately [REDACTED] percent on its \$ [REDACTED] investment.

At first blush, the issuance and redemption of the Series A Preferred Stock had economic substance, because it produced an economic benefit for [REDACTED]. The issuance and redemption of the Series A Preferred Stock, however, did not produce any economic benefit for the Taxpayer and its consolidated group of corporations as a whole. It simply provided a means for the

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<sup>2</sup> Percent of Series A Preferred Stock owned by [REDACTED] = [REDACTED]. Dividends distributed to [REDACTED] = [REDACTED] x \$ [REDACTED] = [REDACTED].

Taxpayer to shift money from one subsidiary to another and to increase its basis in [REDACTED]

A taxpayer may not "reduce his tax liability by transferring his money from one pocket to another even though he uses different pairs of trousers." Waterman Steamship Corp. v. Commissioner, 430 F.2d 1185, 1193 (5th Cir. 1970), cert. denied, 401 U.S. 939 (1971) (citing Minnesota Tea Co. v. Helvering, 302 U.S. 609 (1938)). In essence, in this case, the Taxpayer has done just that. The Taxpayer wanted to withdraw \$[REDACTED] from [REDACTED] prior to its sale to [REDACTED]. See [REDACTED]. But, at the same time, it did not want to decrease its basis in [REDACTED] and, thus, increase the amount of gain on the sale to [REDACTED]. In order to meet these objectives, the Taxpayer devised a scheme in which it created E&P for [REDACTED] which completely offset any diminution in E&P (and/or the Taxpayer's basis in [REDACTED]) resulting from the withdrawal of \$[REDACTED]. This scheme did not have any real or practical economic impact on the Taxpayer or the consolidated group as a whole, because it did not produce any economic profit for the consolidated group as a whole and did not result in a liability for income taxes as the dividends were excluded from gross income pursuant to Treasury Regulation § 1.1502-13(f)(2).

### Business Purpose

The inquiry regarding the business purpose for engaging in a transaction involves a subjective analysis of the taxpayer's intent. Winn-Dixie, 113 T.C.M. (C) 21 (1999). In particular, the courts will evaluate whether the transaction served a useful non-tax purpose. ACM Partnership, 157 F.3d at 253. The courts will do this even though the governing statutory provision may not impose a business purpose requirement. Id. (citing United States Wexler, 31 F.3d 117, 124 (3rd Cir. 1994)).

In this case, [REDACTED] stated its purpose for issuing the Series A Preferred Stock as a need for capital to finance the acquisition of other companies and/or product lines. See [REDACTED]. [REDACTED] months later, [REDACTED] abandoned these pursuits and redeemed the Series A Preferred Stock. See [REDACTED].

(b)(7)a [REDACTED]

[REDACTED] We note, however, that the issuance and redemption of Series A Preferred Stock coincided with various steps taken in the negotiations between the Taxpayer and [REDACTED] for the sale of [REDACTED]. Here is a brief time line outlining the course of events:

1. [REDACTED] - The Taxpayer and [REDACTED] began negotiations for the sale of [REDACTED].
2. [REDACTED] - The Taxpayer and [REDACTED] met to discuss the sale of [REDACTED] and reached some basic terms, including an agreement that the Taxpayer would withdraw \$ [REDACTED] out of [REDACTED].
3. [REDACTED] - [REDACTED] contributed \$ [REDACTED] to [REDACTED] in exchange for Series A Preferred Stock.
4. [REDACTED] - [REDACTED] redeemed all of the Series A Preferred Stock held by [REDACTED] for \$ [REDACTED].
5. [REDACTED] - [REDACTED] distributed approximately \$ [REDACTED] to the Taxpayer.
6. [REDACTED] - The Taxpayer and [REDACTED] executed a letter of intent setting forth the terms of the sale of [REDACTED].

Although circumstantial, the relationship between these events suggests a tax motive for the issuance and redemption of the Series A Preferred Stock, i.e., the creation of basis in [REDACTED] stock held by the Taxpayer and, therefore, a reduction in the amount of gain realized on the sale of [REDACTED].

Moreover, [REDACTED] did not use the cash contributed by [REDACTED] and [REDACTED] in furtherance of its business. After the issuance of the Series A Preferred Stock, [REDACTED] purchased \$ [REDACTED] in marketable securities and left \$ [REDACTED] as cash. See [REDACTED]'s Schedule [REDACTED] for the fiscal year ending [REDACTED]. After the redemption, [REDACTED] no longer held the marketable securities and no longer had \$ [REDACTED] in cash. See [REDACTED]'s Schedule [REDACTED] for the fiscal year ending [REDACTED]. (b)(7)c

[REDACTED]

[REDACTED]

#### Recommendations

(b)(7)a

[REDACTED]

[REDACTED]

[REDACTED]:

1. (b)(5)(AC), (b)(7)a  
(b)(5)(AC), (b)(7)a

2.


3.

4.

(b)(5)(AC), (b)(7)a

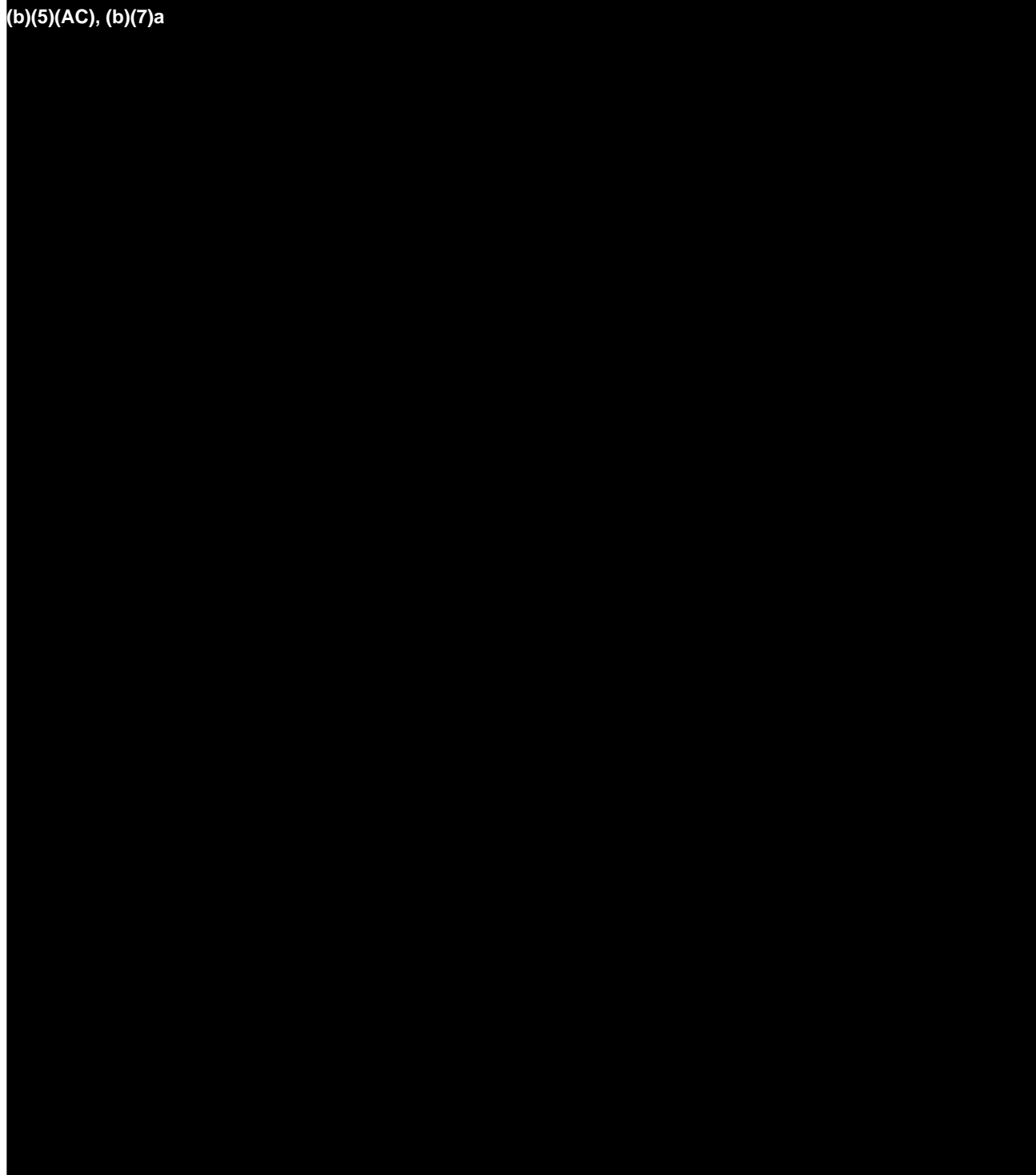
(b)(5)(AC), (b)(7)a

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### III. OTHER ARGUMENTS

(b)(5)(AC), (b)(7)a

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See Stock Purchase Agreement, § [REDACTED] and Art. [REDACTED].

[REDACTED]  
(b)(5)(AC)  
[REDACTED].

If you have any questions, please call the undersigned at  
(619) 557-6014.

GORDON L. GIDLUND  
Assistant District Counsel

By:

A handwritten signature in cursive script, appearing to read "Gretchen A. Kinde".

GRETCHEN A. KINDEL  
Attorney